DEPARTMENT OF STATE REVENUE

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Letter of Findings: 02-20120382; 02-20120383
Corporate Income Tax
For the Years 2008, 2009, and 2010

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ISSUE

I. Commodity Futures Receipts – Corporate Income Tax.

Authority: 7 U.S.C.S. § 6c; IC § 6-3-2-1(b); IC § 6-3-2-2(b); IC § 6-3-2-2(e); IC § 6-3-2-2(g); IC § 6-3-2-2(k); IC § 6-8.1-5-1(c); Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (U.S. 1979); Board of Trade of City of Chicago v. Christie Grain & Stock Co., 198 U.S. 236 (1905); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Sherwin Williams Co. v. Indiana Dep't of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); New Mexico Timber Co. v. Comm'r, 84 T.C. 1290 (1985); The Hoover Co. v. Comm'r, 72 T.C. 206 (1979); Meade v. Commissioner, 12 T.C.M. (C.C.H.) 200 (1973); Muldrow v. Comm'r, 38 T.C. 907 (1962); Sicanoff Vegetable Oil Corp. v. Comm'r, 27 T.C. 1056 (1957), revd. 251 F.2d 764 (7th Cir. 1958); General Mills, Inc. v. Franchise Tax Bd., 146 Cal. Rptr. 3d 475 (Cal. App. 2012); General Mills v. Franchise Tax Board, 92 Cal. Rptr. 3d 208 (Cal. Ct. App. 2009); 45 IAC 3.1-1-34; 45 IAC 3.1-1-50; 45 IAC 3.1-1-50(5); 45 IAC 3.1-1-62; 35 Ill. Comp. Stat. 5/304(a)(3)(C-5)(iii); Ill. Admin. Code tit. 86, 110.3380(c)(5); Black's Law Dictionary (7th ed. 1999).

Taxpayer argues that the gross proceeds from the sale of futures contracts should be reported for purposes of apportioning its income.

STATEMENT OF FACTS

Taxpayer is in the business of processing and producing wheat flour. A related company is in the business of producing various food commodities. The Department of Revenue ("Department") conducted an income tax audit of both "Taxpayer" and "related company." For simplicity's sake, both entities are hereinafter referred to in this Letter of Findings simply as "Taxpayer" because the issues raised in the two audits are identical.

Both audits resulted in the assessment of additional income tax. Taxpayer objected to the additional assessments and submitted protests to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Commodity Futures Receipts – Corporate Income Tax.

DISCUSSION

Taxpayer engages in "hedging contracts" in which it buys and sells commodity futures. In preparing its Indiana corporate tax returns, Taxpayer reported the gross proceeds from the sale of these futures contracts. The amount of gross proceeds was used to determine the amount of "sales everywhere" for apportionment purposes.

The audit disagreed concluding that "Taxpayer should only have reported the net gain from the sale of... futures contacts (Hedging Transaction Receipts) to determine the proper amount of everywhere sales for apportionment purposes."

The audit reasoned that "hedging activities are very similar in nature to investments as it appears the same capital or principal is reinvested over and over to buy and sell contracts that involve hedging the [T]axpayer's risk on the purchase and sale of the various commodities."

The audit pointed to two authorities for its decision. The audit cited to Sherwin Williams Co. v. Indiana Dep't of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996), as authority for its decision stating that "'Gross Receipts' for the purposes of the sales factor includes only the interest income and not the rolled over capital or return of principal realized from the sale of investment securities."

In addition, the audit also cited to 45 IAC 3.1-1-50 which states that "sometimes certain gross receipts should be disregarded to effectuate an equitable apportionment." The cited regulation states in relevant part:

> In some cases, certain gross receipts should be disregarded in determining the sales factor to effectuate an equitable apportionment. 45 IAC 3.1-1-50(5).

The audit concluded that the Taxpayer's inclusion of gross proceeds from the sale of the hedging contracts resulted in a "distortion when ultimately determining the [T]axpayer's Indiana income."

The audit reasoned that:

> The gross hedging receipts do not represent apportionable sales. Therefore, [the] audit basically excludes from the sales denominator the principal return in hedging transactions because to do otherwise would not lead to an equitable apportionment of [T]axpayer's income.

Taxpayer objects to this second premise arguing that the plain language of the Indiana Code mandates that all gross receipts from its sales of commodity futures be included as apportionable sales.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A. Indiana's Adjusted Gross Income Tax:

Indiana corporate income tax is based on a taxpayer's "adjusted gross income" derived from sources within Indiana. IC § 6-3-2-1(b). To determine the amount of "adjusted gross income" derived from Indiana sources, all business income is apportioned to Indiana by means of a three-factor formula; the formula consists of a property, payroll, and sales factor. IC § 6-3-2-2(b).

For the tax year 2008, the Taxpayer's sales factor represents approximately 70 percent of the apportionment formula; the property and payroll factors represent approximately 15 percent each.

For the tax year 2009, the Taxpayer's sales factor represents approximately 80 percent of the apportionment formula; the property and payroll factors represent approximately 10 percent each.

For the tax year 2010, the Taxpayer's sales factor represents approximately 90 percent of the apportionment formula; the property and payroll factors represent approximately 5 percent each.

For purposes of resolving the question at issue in this Letter of Findings, only the sales factor is at issue.

IC § 6-3-2-2(e) states that, "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the table year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property...."

For purposes of Indiana's adjusted gross income tax, "The term 'sales' means all gross receipts of the taxpayer not allocated under IC 6-3-2-2(g) through IC 6-3-2-2(k)...." 45 IAC 3.1-1-34 provides that "any business income of a corporate taxpayer is considered to be from 'sales' under this definition, regardless of its actual source."

B. Audit Conclusion:

The Department's audit concluded that "Taxpayer should only have reported the net gain from the sale of [] future contracts to determine the property every sales for apportionment purposes." The audit believed its decision, requiring Taxpayer to report its hedging transactions on a net basis, was justified for two reasons.

As noted above, the audit report cited to 45 IAC 3.1-1-50(5) which states in part that, "In some cases, certain gross receipts should be disregarded in determining the sales factor to effectuate an equitable apportionment." The cited regulation cross-references 45 IAC 3.1-1-62 which provides:

> Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results. (Emphasis added).

In addition, the audit report cites to Sherwin-Williams Co. v. Ind. Dep't of Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996) as authority for its position. In that case, the Department argued that petitioner, Sherwin-Williams, should only have included the interest earned on investment security transactions as gross receipts for apportionment purposes. Id. at 851. The Department maintained that "the inclusion of principal in the denominator distorts the apportionment formula by giving extra weight to out-of-state sales... because [petitioner] could use the same principal many times as it reinvests in short-term securities rolling over the principal of the previously sold investment." Id. The court agreed with the Department's position concluding that, for purposes of calculating the petitioner's adjusted gross income taxes, the denominator of the sales factor in the apportionment formula should only include interest income, not the rolled over capital or return of principal, realized from the petitioner's sale of investment securities. Id. at 853.

Therefore, the audit's position is based on two premises: (1) Taxpayer's hedging transactions were similar to serial investments in which the same capital is repeatedly invested and reinvested; (2) the gross receipts should be disregarded to fairly effectuate an equitable apportionment of Taxpayer's income.

C. Taxpayer's Argument:

Taxpayer disagrees and points to General Mills v. Franchise Tax Board, 92 Cal. Rptr. 3d 208 (Cal. Ct. App. 2009) (General Mills I) as authority for its position. The issue in that case was – under California's three-factor apportionment scheme – to what extent petitioner General Mills' receipts from the sale of futures contracts should be included in the sales factor of California's standard apportionment formula. Id. at 213. The petitioner argued

that the full sales price of all of its futures sales contracts should be included in the sales factor while the state maintained that only the net gain of the futures sales contracts should included. Id. at 213-14. The court agreed with the petitioner's argument finding that petitioner's "'gross receipts' from a futures sales contract are equivalent to the full sales price of the contract. 'Gross' means 'the full amount received, not the company's net gain on the transaction or 'gross income' from the transaction." Id. at 218. The court concluded that, "The full sales price of [petitioner's] hedging futures sales contracts are 'gross receipts' to be included in the calculation of the UDITPA sales factor." Id. The court stated:

> When a futures sales contract results in a physical delivery, General Mills receives the full sales price in cash (in part through the mark-to-market process and in part upon delivery). When a futures sales contract results in offset or when the company offsets an open futures purchase contract, General Mills receives consideration in the form of being relieved of the obligation to purchase or sell the commodity under the contract. That consideration, in combination with any sums General Mills received through the mark-to-market process, equals the full sales price of the contract. The Franchise Tax Board's proposed methodology – counting only net gains on futures contracts – is facially inconsistent with the "gross receipts" definition of sales. Id.

However, the court remanded the issue to the trial court to determine whether the Franchise tax Board met its burden of proving that the apportionment formula did not "fairly represent" General Mills' business within California thereby warranting imposition of an alternative apportionment formula. Id. On remand, the Franchise Tax Board argued that General Mills' principal trade or business was the manufacture and marketing of finished consumer products and that the sale of raw and grain and grain products represented only a small portion of General Mills' business. General Mills, Inc. v. Franchise Tax Bd., 146 Cal. Rptr. 3d 475, 486-88 (Cal. App. 2012) (General Mills II). The court ultimately accepted the Franchise Board's argument that the commodity futures sales were qualitatively different from General Mills' principal business and that including the futures income in the sales factor distorted General Mills' apportionment formula. Id. at 491-94.

> [W]e agree with the court's ultimate conclusion that including futures sales in the sales factor quantitatively distorts the standard apportionment formula such that it does not fairly represent the extent of General Mills's business in California. In particular, we agree that a key quantitative metric – profit margin – weighs heavily in favor of a finding of substantial distortion... [W]e conclude it is sufficient in all the circumstances to warrant application of [Cal. Rev. & Tax Code § 25137]. (authorizing an alternative method of calculating income attributable to business activity in California where a particular business function is qualitatively different from the taxpayer's principal business). Id. at 489.

Taxpayer states that General Mills II is not applicable to the determination of whether 45 IAC 3.1-1-50 is applicable to Taxpayer's own specific facts. Taxpayer explains that if General Mills had been engaged in primarily the same business as Taxpayer – producing, processing, and merchandising commodities – it would not have been distortive to include General Mills' futures market sales in the sales factor under the Franchise Tax Board's own arguments. Taxpayer states, "[A]lthough General Mills I is directly applicable to [Taxpayer's] protest. General Mills II is factually distinguishable and there inapplicable to [Taxpayer's] protest."

D. Background Definitions: "Futures"/ "Hedging" / "Offsets":

Taxpayer explains that it is in the business of "procuring, transporting, storing, processing, and merchandising agricultural commodities requiring it to buy and sell commodities in order to continue its day-to-day operations."Taxpayer explains that the price and availability of commodities are "highly volatile due to factors such as weather, planting, freight costs, government policies, and market demand." Taxpayer further explains that in order to reduce the risks associated with volatile prices, Taxpayer buys and sells commodities in the futures market in a practice known as "hedging."

A futures contract is defined as "[a]n agreement to buy or sell a standardized asset (such as a commodity, stock, or foreign currency) at a fixed price at a future time, [usually] during a particular time of month." Black's Law Dictionary 685 (7th ed. 1999).

"Hedging" is defined as "[making] advance arrangements to safeguard oneself from loss on an investment, speculation, or bet, as when a buyer of commodities insures against unfavorable changes by buying in advance at a fixed rate for later delivery." Id. at 726.

The California Court of Appeals in General Mills I described the petitioner's hedging transactions as follows:

> [T]he process of hedging protects [petitioner] against the risk of fluctuations in the price of agricultural commodities [petitioner] uses in its business. To understand [petitioner's] hedging transactions, we define several concepts involved in the hedging process. A futures contract is an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) that obligates each party to the contract to fulfill the contract at the specified price; (3) that is used to assume or shift price risk; and (4) that may be satisfied by delivery or offset. "Offset" means liquidating a purchase of futures contracts through the sale of an equal number of contracts of the same delivery month, or liquidating a short sale of futures through the purchase of an equal number of [purchase] contracts of the same delivery month.
>
> "Hedging" means (1) taking a position in the futures market opposite to a position held in the cash market to

minimize the risk of financial loss from an adverse price change; or (2) purchasing or selling commodities on the futures market as a temporary substitute for a cash transaction that will occur later. The purpose of hedging is to smooth out price fluctuations so [petitioner] can operate despite the price volatility in the agricultural commodities it uses to manufacture its consumer products. If [petitioner] did not hedge the price of grain, it would encounter severe fluctuations in its costs of goods. General Mills I, 92 Cal. Rptr. 3d at 210.

Taxpayer cites to the "U.S. Commodity Futures Trading Commission" (CFTC) for its definition of "futures contracts." A futures contract is defined by the CFTC as:

An agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contracts; (2) that obligates each party to the contract to fulfill the contract at a specified price; (3) that is used to assume or shift price risk; and (4) that may be satisfied by delivery or offset. U.S. Commodity Futures Trading Commission, http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_f (last accessed February 19, 2013)

Taxpayer explains that other than price, quantity, and delivery month, all other terms are set by the exchange on which the futures contracts are traded.

As Taxpayer explains, once it enters into a particular futures contract, Taxpayer – on or before the date the commodity is to be delivered – has two options: (1) Taxpayer can deliver or accept delivery of the commodity; or (2) enter into a separate futures contract with a third party to purchase or sell the same amount of the commodity for the same delivery month thereby offsetting the original futures contract. This offset constitutes performance of the original futures contract. Taxpayer explains that most futures contracts are satisfied by an offset in this manner. Essentially, a "futures contract" and an "offsetting futures contract" go hand-in-hand in the practice known collectively as "hedging."

Taxpayer offers examples to explain the nature of the transactions central to the disputed issues.

(1) Taxpayer Example One:

Taxpayer provides an example of an offset transaction:

• On Day 1, Taxpayer enters into a contract with Acme, Co. under which Taxpayer agrees to buy 10 bushels of wheat from Acme, Co. for delivery on Day 10. Taxpayer agrees to pay $5 per bushel ($50).

• To offset this first contract, on Day 5, Taxpayer enters into a second contract also with Acme Co. under which Taxpayer agrees to sell 10 bushels of wheat to Acme, Co. for delivery on Day 10. Taxpayer agrees to sell the wheat for $10 per bushel ($100).

• Between Day 1 and Day 5, the price of wheat increases from $5 per bushel to $10 per bushel.

• Both contacts are satisfied and performed but rather than; (1) Taxpayer paying Acme $50 and shipping 10 bushels of wheat to Acme, Co.; (2) Acme, Co. paying Taxpayer $100 and shipping 10 bushels of wheat to Taxpayer; (3) the contracts are offset; and (4) Acme, Co. simply pays Taxpayer $50.

Taxpayer indicates that the "offset" prevents the parties from incurring unnecessary transaction costs in shipping the wheat back and forth between each the two parties. In the example set out above, wheat is neither shipped nor delivered.

Taxpayer maintains the consideration it received for its sales contract is $100 because, "based on over 100 years of federal authorities," Acme, Co's performance of the second contract described above is the same as if it had actually received delivery of the grain and paid Taxpayer $100 for that grain. Taxpayer received $50 in cash consideration and $50 in relief of its indebtedness to Acme, Co. under the contract entered into on Day 1.

The audit's position was that the value of the two contracts should have been netted and that – for purposes of determining Taxpayer's Indiana adjusted gross income – the total sale was $50.

(2) Taxpayer Example Two:

Taxpayer points out that futures exchanges operate clearinghouses that act as intermediaries to the parties to a future contract. By conducting its business through a clearinghouse, Taxpayer explains that it is able to enter into an offsetting contract with a different party than in the initial contract.

• In a variation on Example 1 above, if Taxpayer's initial contract was with Acme, Co. by which Taxpayer agreed to buy 10 bushels of wheat at $5 per bushel for delivery on day 10,

• Taxpayer could offset that same contract by contracting with Food, Inc. (not Acme, Co.) to sell 10 bushels of wheat to Food, Inc. at $10 per bushel for delivery on Day 10.

• The futures exchange would credit Taxpayer's account with $50 which consists of the $100 received from Food, Inc. less the $50 owed Acme, Co.; (The futures exchange actually marks-to-market all open positions on a daily basis.) Taxpayer would neither deliver nor receive any wheat. The futures exchange would simultaneously make corresponding modifications to the accounts of Acme, Co. and Food, Inc.

Taxpayer maintains the consideration it received for its sales contract with Food, Inc. is $100 because, "based on over 100 years of federal authorities, including U.S. Supreme Court case law," Food, Inc.'s performance of the contract is the same as if it had actually received delivery of the grain and paid $100 for that grain. Taxpayer received $50 in cash consideration and $50 in relief of its indebtedness to Acme, Co under the contract entered into on Day 1.

Taxpayer maintains that it "earned" $100 on the "sale" of wheat to Food, Inc.

The audit's position was that the value of the two contracts should have been netted and that – for purposes of determining Taxpayer's Indiana adjusted gross income – the total sale was $50.

(3) Taxpayer Example Three:

Taxpayer offers a third "real world" example of a futures contract and a corresponding hedging contract.

- Taxpayer contracts with Bakery, Inc. to sell Bakery, Inc. flour in 6 months (180 days) for $60.
- To mill and supply this flour, Taxpayer knows that it will need to purchase 10 bushels of wheat just prior to the date it is required to deliver the flour in six months.
- Taxpayer based the $60 flour sale price on the assumption that the wheat would cost Taxpayer about $50 (10 bushels at $5 per bushel).
- If the price of the wheat increased in the next 180 days, Taxpayer would either lose money on the flour contract with Bakery, Inc. or would be required to default on the contract.
- To hedge against the risk of an increase in the price of wheat, Taxpayer enters into a contract with a third party on the futures market to purchase 10 bushels of wheat at $5 per bushel for delivery to Taxpayer on day 180.
- If on day 180, the price of wheat had risen from $5 per bushel to $10 per bushel:
  - Taxpayer would purchase 10 bushels of wheat for $10 per bushel ($100);
  - Taxpayer then offsets its futures purchase contract by entering into a futures sales contract to sell 10 bushels of wheat at $10 per bushel (a receipt of $100). Because the original futures contract cost Taxpayer $50 (10 bushels at $5 per bushel) this constitutes a gain to Taxpayer of $50.
- According to Taxpayer, the total cost of Taxpayer's wheat ends up being only $50 ($100 direct cost less the $50 gain in the futures market) rather than the $100 it would other would have cost Taxpayer.

In Taxpayer's example three, "hedging" permitted Taxpayer to contract and sell Bakery, Inc. flour in six months without concern for fluctuations in the costs of the wheat needed to fulfill the contract.

When asked to explain Taxpayer's calculation of gross receipts received under Taxpayer's own Example 3, Taxpayer averred stating that it was not possible to determine the income in isolation because in Taxpayer's hedging operations – only a portion of which is reflected in Example 3 – the sample transactions would be "inextricably connected with the rest of [Taxpayer's] business." Similarly, Taxpayer does not explain what the net income would be in a "real world" analogue of Example Three.

E. Taxpayer's Application of Fact, Industry Practice, and Law:

Taxpayer argues "hedging" is a critical part of its fundamental business and that without "hedging" it would not be able to compete with other businesses. Taxpayer argues that the audit erroneously included only Taxpayer's yearly net gains from its sales on the commodity future market in its sales factor.

As authority for its position, Taxpayer cites to IC § 6-3-2-2(e) which states in part, "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property." (Emphasis added).

Taxpayer states that for purposes of determining Indiana's adjusted gross income tax "[t]he term 'sales' means all gross receipts of the taxpayer not allocated under IC § 6-3-2-2(g) through IC § 6-3-2-2(k) other than compensation."

Taxpayer points out that neither it nor the Department dispute that money earned from hedging activities contributes to Taxpayer's "business income" and that the money is, therefore, not allocated under IC § 6-3-2-2(g) through IC § 6-3-2-2(k).

Taxpayer maintains that under Indiana law, the gross receipts from its hedging activities must be included in Taxpayer's sales factor denominator. According to Taxpayer, IC § 6-3-1-24 provides that, "The term 'sales' means all gross receipts of the taxpayer...." (Gross receipts consists of "The total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deductions." Blacks Law Dictionary 710 (7th ed. 1999)).

In addition, Taxpayer points to federal court decisions holding that an offsetting purchase agreement is treated the same way as if the taxpayer actually delivered the commodity and received compensation for that delivery. "The sales in the [trading] pits art not pretended, but, as we have said, are meant and supposed to be binding. A set-off is, in legal effect, a delivery." Board of Trade of City of Chicago v. Christie Grain & Stock Co., 198 U.S. 236, 249-50 (1905);

> We must suppose that from the beginning, as now, if a member had a contract with another member to buy a certain amount of wheat at a certain time, and another to sell the same amount at the same time, it would be deemed unnecessary to exchange warehouse receipts. We must suppose that then as now, a settlement would be made by the payment of differences, after the analogy of a clearing house. This naturally would take place no less that the contracts were made in good faith, for actual delivery, since the result of actual delivery would be to leave the parties just where they were before. Set-off has all the effects of delivery. Lyons Milling Co. v. Goffe & Carkener, 46 F.2d 241, 247 (10th Cir. 1931) (quoting with approval Board of Trade of City of Chicago v. Christie Grain & S. Co., 198 U.S. 236, 248 (1905).

Taxpayer also cites to various United States Tax Court decisions as authority for its position. "Settlement of a

commodity futures contract by offset constitutes a sale or exchange of the original commodity futures contract." New Mexico Timber Co. v. Comm'r., 84 T.C. 1290, 1300 (1985); the most common method of settling a forward sale contract has traditionally been to enter into a purchase contract and to offset the contractual obligations to sell and purchase. Meade v. Commissioner, 12 T.C.M. (C.C.H.) 200 (1973); Muldrow v. Comm'r, 38 T.C. 907, 910 (1962); Sicanoff Vegetable Oil Corp. v. Comm'r., 27 T.C. 1056, 1059, 1063 (1957), rev'd. 251 F.2d 764 (7th Cir. 1958). "[T]he most common method of settling a forward sale contract has traditionally been to enter into a purchase contract and to offset the contractual obligations to sell and purchase. Offset of the contractual obligations by the seller has been held to be delivery under the sale contract satisfying the sale or exchange requirement on the date the contract is settled." Hoover Co. v. Comm'r, 72 T.C. 206, 249 (1979) (Internal citations omitted).

In addition, Taxpayer disagrees with the audit's reliance on Sherwin-Williams. In that decision, the court disagreed with the petitioner's contention that – for purposes of determining the amount of its sales factor – it could include both the amount of principal and the amount of interest it received in the periodic reinvestment of working capital. Id. at 853. The court agreed that "only profits or earnings, and not the return of invested capital, were to be taxed as gross income." Id. at 852. Taxpayer differentiates the circumstances in Sherwin-Williams from its own trades, stating that its hedging receipts are nor derived from a "treasury function" or a simple "return of capital." Taxpayer contends its hedging receipts "arise from binding obligations to deliver a specified commodity at a specified price in a specified month", that Taxpayer receives gross receipts/consideration equal to the sales price of the commodities at the time the contracts are satisfied," and that the transactions are not the result of simply "churning" the same money repeatedly.

Taxpayer points out that the Commodity Exchange Act as prohibits "wash sales" defined as "A sale of securities made at about the same time as a purchase of same securities... resulting in no change in beneficial ownership." Black's Law Dictionary 1339 (7th ed. 1999). In particular, Taxpayer cites to 7 U.S.C.S. § 6c:

(a) In general

(1) Prohibition

It shall be unlawful for any person to offer to enter into, enter into, or confirm the execution of a transaction described in paragraph (2) involving the purchase or sale of any commodity for future delivery (or any option on such a transaction or option on a commodity) or swap if the transaction is used or may be used to--

(A) hedge any transaction in interstate commerce in the commodity or the product or byproduct of the commodity;

(B) determine the price basis of any such transaction in interstate commerce in the commodity; or

(C) deliver any such commodity sold, shipped, or received in interstate commerce for the execution of the transaction.

(2) Transaction

A transaction referred to in paragraph (1) is a transaction that--

(A)(i) is, of the character of, or is commonly known to the trade as, a "wash sale" or "accommodation trade"; or

(ii) is a fictitious sale; or

(B) is used to cause any price to be reported, registered, or recorded that is not a true and bona fide price.

Taxpayer also points out the Commodity Futures Trading Commission, precluded it from arbitrarily "rolling over" funds to generate gross receipts. The Commission defines "wash trading" as "e]ntering into, or purporting to enter into transactions, to give the appearance that purchases and sales have been made without incurring market risk or changing the traders' market position." CTFC Glossary, U.S. Commodity Future Trading Commissioner (accessed February 7, 2013) http://www.cftc.gov/consumerprotection/educationcenter/cftcglossaryu/glossary_wxyz. Specifically, Chicago Board of Trade Rule 534 ("Wash Trades Prohibited") provides:

No person shall place or accept buy and sell orders in the same product and expiration month, and, for a put or call option, the same strike price, where the person knows or reasonably should know that that the purpose of the orders is to avoid taking a bona fide market position exposed to market risk (transactions commonly known or referred to as wash sales)

Taxpayer cites to its own internal "Code of Conduct" which provides that its employees "must know, understand and follow the laws and regulations that govern the work [done] on the company's behalf."

In addition, Taxpayer cites to Minneapolis Grain Exchange Rule 743 ("Accommodation or Wash Trades Forbidden,") which provides that "[n]o Members shall make risk-free simultaneous purchases and sales of the same month of the same commodity for the same account at the same price." Taxpayer also cites to Kansas City Board of Trade Rule 1171 which states that "[i]t shall be a violation of these Rules to enter into or confirm the execution of any transaction, if such transaction is of the character or, or is commonly known to the trade as a 'wash trade,' 'cross trade,' accommodation trade,' or is a fictitious sale."

F. Analysis:

(1) Issue One:

The first issue is whether the Taxpayer should only have reported the net gain from the sale of futures contracts to determine the proper everywhere sales for apportionment purposes because – as stated in the audit report – "the same capital or principal is reinvested over and over to buy and sell contracts that involve hedging the [T]axpayer's risk on the purchase and sale of the various commodities." The audit report relied on Sherwin-Williams as supporting its position. In that case, the Indiana Tax Court found that only the interest income earned from the petitioner's security investment should be included in the sales factor. Sherwin-Williams, 673 N.E.2d at 853. The court found that including the recovered principal in the apportionment fraction "would be comparable to measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account." Id. at 852. (citing with approval, AT & T v. Director, Division of Taxation, 476 A.2d 800, 802 (N.J. Super. Ct. App. Div. 1984)). Taxpayer has provided evidence and documentation sufficient to establish that the futures contracts and the offsetting futures contracts are not similar to the investments at issue in Sherwin-Williams. Taxpayer's citation to federal case law establishes that futures contracts are not successive, risk-free investments, and reinvestments of the same capital; the futures contracts are a critical and integral part of the Taxpayer's business practice; federal law, the various exchange rules, and its own code of conduct preclude Taxpayer from entering into risk-free, fictional "wash transactions" which create only the illusion of true market activity. In addition, although not dispositive, the Department finds the court's reasoning in General Mills I instructive because the court found that the full sales price of General Mills' futures contracts should be included in the sales factor.

2. Issue Two:

The second issue is whether the audit was correct in concluding that it was entitled to substitute "net receipts" for "gross receipts" to determine Taxpayer's Indiana sales factor in order to "effectuate an equitable apportionment" as permitted under 45 IAC 3.1-1-50. ("In some cases, certain gross receipts should be disregarded....") Was the audit correct in "disregarding" Taxpayer's gross receipts?

The regulation permits the Department to resort to an alternative method of apportioning a Taxpayer's income. The prerequisites to doing so are set out in part at 45 IAC 3.1-1-62:

> [T]he Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

The audit concluded that, "The Taxpayer's inclusion of the total or gross proceeds from the hedging transactions results in a distortion when ultimately determining the [T]axpayer's Indiana income."

Taxpayer's argument is that it should attribute its hedging receipts to Illinois as its commercial domicile. Using one of the companies as an example, based on the apportionment information provided, and if hedging receipts are disregarded, Taxpayer has approximately ten to twelve percent of its overall receipts attributable to Illinois. Taxpayer represents to Indiana that between 65 percent and 78 percent of its overall activities are attributable to Illinois. However, Illinois law requires the inclusion of net gain from the sale of stocks and other intangibles. 35 Ill. Comp. Stat. 5/304(a)(3)(C-5)(iii) (effective January 1, 2009). Since at least 2002, Ill. Admin. Code tit. 86, 110.3380(c)(5) has provided:

> In the case of sales of business intangibles, (including by means of example, without limitation, patents, copyrights, bonds, stocks, and other securities) gross receipts shall be disregarded and only the net gain (loss) shall be included in the sales factor.

Taxpayer's overall apportionment results in transactions designed to represent a yield of little or no profit reducing Taxpayer's Indiana income by over $20,000,000 for the three-year audit cycle. However, Taxpayer is reporting the same receipts to no jurisdiction whatsoever. Taxpayer reported only the net gain – if any – from hedging transactions to Illinois as its domiciliary state. The audit's approach – the approach as Taxpayer reported in its own domiciliary state – reflects Indiana's contribution to Taxpayer's overall profits. The approach assumed by the Department's audit, if adopted by other states, would result in 100 percent of Taxpayer's income being apportioned among the states. Applying Taxpayer's proposed methodology would apportion only 40 percent of its income among the states since the receipts from the futures transactions would be included on a gross basis in every state other than Illinois which is the state where the receipts are sourced.

Taxpayer admits that it reported the income from the futures transactions on a net basis on its federal income tax returns. Similarly, for Securities and Exchange ("SEC") purposes, Taxpayer reported "its future transactions at net in its cost of goods sold for SEC reporting purposes." However, Taxpayer cautions against giving too much weight to these facts. Taxpayer indicates that the fact that it reported net transactions for federal income tax and SEC purposes is irrelevant for state apportionment purposes because "financial account, federal tax accounting, and [state tax] apportionment have 'vastly different objectives.'" As authority for its position, Taxpayer cites to Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979) which held:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties

from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." Id. at 542.

Taxpayer also cites to General Mills I, 92 Cal. Rptr. 3d at 217 which states that "[T]he company's financial accounting treatment of the [futures] trades is not binding for tax purposes. Financial and tax accounting have 'vastly different objectives.'"

The audit cited to 45 IAC 3.1-1-50 to justify disregarding Taxpayer's gross sales "in order to effectuate an equitable apportionment" of Taxpayer's Indiana income. The audit's decision to do so mirrors Taxpayer's own decision to report net receipts for both federal income tax purposes and SEC purposes. Having done so, there is no indication that Taxpayer's decision to report the income on a net basis worked a "hardship or injustice" upon Taxpayer, that reporting net income for federal purposes resulted in an "arbitrary division of income," or that reporting net income for federal purposes produced an "incongruous results." To the contrary, Taxpayer made an apparently reasoned decision to report its net sales for federal income and SEC purposes. The Department does not agree that for purposes of determining federal income tax, fulfilling its responsibility to report to the SEC, and determining state income tax liability serve such "vastly different objectives" that the audit was incorrect when it required – for apportionment purposes – that the Taxpayer reports its sales in a manner entirely consistent with what it reported to the federal authorities.

As set out in IC § 6-8.1-5-1(c), Taxpayer has failed to meet its burden of "proving that the proposed assessment is wrong...."

FINDING

Taxpayer's protest is respectfully denied.

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